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MBS Meltdown Imminent (Again) and CLO Bubble: Hedge Funds Short on Malls' CMBS Bonds Just the Beginning of Signs of Distress as the End of the "Easy Money" Era Will Add Pressure to the CMBS and CLO Bubbles

By Peter Michael Allen

In a déjà vu of the 2008 financial crisis, the looming crash in mortgage-backed securities (MBS) is becoming more obvious with each passing day. This time, however, the crash will be in the commercial MBS (CMBS) space rather than the residential MBS space. A record amount of commercial real estate leases expire soon due to the pandemic, and top tier commercial landlords Blackstone and Brookfield's recent defaults on CMBS bonds signal an imminent crash for commercial real estate and CMBS. CMBS is a pool of several mortgages of commercial properties. Hedge funds and whistle-blowers have been warning about the bubble in the CMBS market for several years.

Currently, the United States is experiencing the highest rate of inflation in over 40 years and the Federal Reserve Bank's recent interest rate increase of three quarters of a percentage point, the largest increase since 1994,[1] has officially ended the "easy money" era of the Fed's low interest rate policy and "quantitative easing." The end of the "easy money" era will add increasing pressure to the bubble in the CMBS market. On June 13th of this year, the S&P 500 benchmark declined over 20 percent since January, meaning the benchmark was now in a bear market for the first time since the onset of COVID-19 in early 2020.[2]

About $320 billion in distressed commercial real estate is expected to be up for sale over the next five years; a 60 percent increase from the period of 2010 and 2014.[3] Analysts believe that the huge amount of government stimulus of over $4 trillion has delayed defaults, foreclosures, and distressed sales of commercial real estate; but the defaults and foreclosures will eventually occur.[4] According to sources, there is a massive amount of capital from hedge funds and other investors waiting to buy distressed properties at a discount.[5]

Many office building landlords were able to endure the pandemic since commercial tenants were locked into leases. Many of these tenants have now opted not to renew their leases since they need less office space with remote and hybrid work increasing.[6] Leases for 243 million square feet of US office space are on track to expire in 2022; the highest amount of office space to be released to the market in a year since data of this kind started to be tracked in 2015. The expiring leases are about 11 percent of total leased office space in the United States.[7]

In the future, office space is expected to be used less with remote and hybrid work becoming more popular.[8] Consequently, in Manhattan, which has an excessive amount of office buildings, older, less modern office buildings are expected to be left vacant with tenants opting for newer buildings.[9] In Manhattan, the office vacancy rate is now 12.3 percent, up from 7.8 percent in 2020.[10] About 90 percent of office space in Manhattan is over 20 years old. New skyscraper buildings such as Hudson Yards have quickly attracted tenants while older buildings have struggled to secure tenants despite offering steep rent discounts.[11] About 30 percent of office buildings, worth an estimated $1.1 trillion, in the United States are at high risk of becoming obsolete as more tenants move to remote and hybrid work models.[12]

Many commercial real estate property owners with CMBS bonds are looking to refinance and extend the maturity dates on the bonds.[13] But, the "easy credit" era for borrowers has ended.[14] The Fed's periodic interest rate increases have made refinancing generally more complicated and difficult to obtain.[15] For instance, since January of this year, the owner of the 5 Times Square office tower in New York City has been trying to refinance its $1.5 billion in CMBS bonds; the property will soon be 75 percent empty.[16] About $7.16 billion worth of CMBS office debt is maturing in 2022; more than the combined total of the prior three years.[17]

In late March of this year, Brookfield defaulted on its $77 million CMBS bonds for the Bellis Fair Mall in Bellingham, Washington.[18] Likewise, earlier this year, Brookfield's $258 million CMBS bonds on its 175 West Jackson Blvd. property, a 22 story building with1.4 million-square-foot in Chicago, transferred to special servicing and Brookfield gave up possession of the property; indicating that it is several months delinquent on payments and in default on the CMBS bonds.[19] Earlier this year, Brookfield also backed out on a $1 billion deal to buy several office buildings in the waterfront of Jersey City, New Jersey after Amazon decided not to lease office space there.[20] Also earlier this year, Blackstone's $308 million CMBS bonds on its 1740 Broadway, a 26 story office building in New York City, transferred to special servicing and Blackstone gave up possession to the property because Blackstone defaulted on the CMBS bonds.[21]

After an investigation, ProPublica, a nonprofit whistleblower, reported that Wall Street has once again engaged in widespread manipulation of MBS by grossly overvaluing the underlying portfolio properties of CMBS; the fraud is similar in scope and severity as what occurred with residential MBS in 2008. By grossly overvaluing commercial properties, lenders were able to award borrowers larger CMBS debt than supported by the properties' true value.[22]

Shorting of Malls' CMBS Bonds

Last year, Carl Icahn profited $1.3 billion by shorting the CMBX 6 index, which he did by purchasing credit default swaps.[23] The CMBX 6 index tracks several CMBS bonds and has a high amount of CMBS bonds of malls and other commercial properties. Hedge funds and Icahn chose to short the CMBX 6 index because the index has a high amount of exposure to malls. Prior to the pandemic in late 2019, after conducting research and analysis, Icahn and other analysts became convinced that a great deal of commercial mortgages and CMBS for malls would default, and, thus they viewed mortgages and CMBS bonds for malls as a shorting opportunity.

Due to its struggling US malls business, mall owner Westfield, which is based in Paris, plans to divest all of its 29 malls in the United States by late 2023.[24] Westfield already has defaulted on a few of its CMBS bonds and CMBS bondholders are concerned that Westfield may default on more of its CMBS bonds; Westfield has about $3.4 billion CMBS bonds.[25] Since 2017, the underlying mortgages of distressed regional malls within CMBS have experienced a weighted average loss of about 75 percent.[26]

Hedge funds and other institutional investors often are the first to recognize fraud, bad conduct and mismanagement. Institutional investors often use shorting, meaning to bet on the decline of an asset or a stock, either by purchasing credit default swaps, selling a stock or purchasing put options. Parties managing companies, securities and assets have a tendency to poorly manage and/or engage in fraud without proper checks and balances.

The current crisis in the CMBS market once again demonstrates the shortcomings of our current system of checks and balances. Hedge funds, institutional investors, and private plaintiff lawsuits help fill the void caused by ineffective regulations and enforcement. While fraud and deceptive financial reporting are rampant, they often are complex and require a great deal of investigative work to bring to light. Institutional investors and hedge funds often are the first to identify fraudulent or poorly managed companies or investment products such as CMBS. Plaintiff attorneys who file private lawsuits for securities fraud or other claims make use of the prior due diligence and research from institutional investors and financial analysts.

In addition to increased monthly debt payments due to the Fed's rate increases, borrowers also have to pay substantially more for interest rate cap insurance.[27] CMBS usually require borrowers obtain interest rate caps, a type of insurance to protect monthly debt payments from increasing out of control when the Fed increases interest rates.[28] The price for such insurance has increased by 10 times this year because of the Fed's rate increases.[29]

Recently, CMBS bonds have been re-defaulting.[30] At least 13 CMBS bonds that defaulted in 2020 have re-defaulted this year; the defaults are mainly retail and office mortgages that have lost tenants and are struggling to make debt payments.[31] Due to the pandemic, many hotels' CMBS bonds are in distress and are at high risk for default. Hedge funds and investors may be shorting the CMBX 9 index, an index with a high amount of exposure to the debt of hotels, according to sources.[32]

CLO Bubble

After over a decade of "easy money" from the Fed's quantitative easing and low interest rates along with the reckless issuing of collateralized loan obligation (CLO) financings by Wall Street firms, a bubble has formed in the CLO market. The massive stimulus from the Fed in 2020 in response to the COVID-19 pandemic has further inflated the CLO bubble. Both CMBS and CLO are "securitized" products that pool several debt agreements. A CLO is a pool of several corporate loans.

In addition to the CMBS bubble, the unprecedented amount of CLO financing held by financial institutions could lead to a potential collapse in the financial system worse than the 2008 crash that bankrupted Lehman Brothers and other financial institutions.[33] Many large US companies have obtained several CLO financings such as AMC, which holds about $2 billion of debt in 224 CLOs and Party City, which holds $719 million of debt in 183 CLOs.[34]

For the year 2021, the Fed's stimulus, along with investors' appetite for yield, resulted in institutions issuing a record amount of CLO financing.[35] As of 2021, nonfinancial companies have total debt of 11.2 trillion, about half of the size of the US economy.[36] In 2020 alone, nonfinancial companies issued $1.7 trillion of bonds in the United States; about $600 billion more than in 2019.[37]

The Fed's interest rate increases are leading to a tightening of credit, which likely will lead to an increase of struggling companies with liquidity problems and lead to credit downgrades in CLOs. If CLOs are downgraded by just one rating from B- to CC their prices could take a dive as many money managers have strict limits on the amount of CCC debt they can hold.[38] The drying up of credit along with the increasing costs due to inflation and interest expense likely will lead to a significant increase in corporate insolvencies and could burst the CLO bubble.

At least one hedge fund views the current financial system to be in "the greatest credit bubble of human history."[39] Recently, JPMorgan Chase has warned investors to prepare for a potential economic "hurricane."[40]

Conclusion

The end of the Fed's "easy money" era will put increasing pressure on the debt bubbles in the CMBS and CLO markets. Given the tightening credit markets, high debt loads of companies, increased business costs due to inflation and current bear stock market, the bubbles in the CMBS and CLO markets will likely burst in the near future. The bursting of the CMBS and CLO market bubbles will likely negatively impact the stock market as in 2008-2009 with the collapse of the residential MBS market since financial institutions have at least some exposure to CMBS and CLOs, and a substantial amount of publicly traded companies will likely default on debt and fall into distress and file for chapter 11 bankruptcy.

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